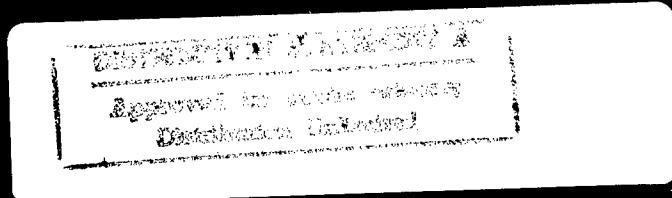


GAO

United States General Accounting Office
High-Risk Series

February 1997

Defense Contract Management



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Washington, D.C. 20548

Comptroller General
of the United States

*Defense Contract
Management*

February 1997

The President of the Senate
The Speaker of the House of Representatives

In 1990, the General Accounting Office began a special effort to review and report on the federal program areas its work identified as high risk because of vulnerabilities to waste, fraud, abuse, and mismanagement. This effort, which was supported by the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight, brought a much-needed focus on problems that were costing the government billions of dollars.

In December 1992, GAO issued a series of reports on the fundamental causes of problems in high-risk areas, and in a second series in February 1995, it reported on the status of efforts to improve those areas. This, GAO's third series of reports, provides the current status of designated high-risk areas.

This report discusses the high risks in contract management that the Department of Defense continues to face, despite improvements in selected areas.

GAO/HR-97-4

Copies of this report series are being sent to the President, the congressional leadership, all other Members of the Congress, the Director of the Office of Management and Budget, and the heads of major departments and agencies.

A handwritten signature in black ink, appearing to read "James F. Hinchman".

James F. Hinchman
Acting Comptroller General
of the United States

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Overview

Improvement and simplification of the Department of Defense's (DOD) contract payment system is imperative. If DOD does not achieve effective control over its payment process, DOD's Defense Finance and Accounting Service (DFAS) will continue to risk overpaying contractors millions of dollars. Further, failure to reform the payment system perpetuates other financial management and accounting control problems and increases the administrative burden of identifying and correcting erroneous payments and their associated costs. DOD is aware of the seriousness of its payment problems and is taking steps to address them.

With improved contractor cost-estimating systems, DOD could reduce the risk of overpricing and manage contracts more efficiently. Contractors' cost-estimating systems are a critical control for ensuring sound price proposals. Sound price proposals reduce the risk that the government will pay excessive prices, and they permit less government oversight and management attention. DOD has improved its oversight of contractors' cost-estimating systems, and some improvement in contractor systems is indicated. Nevertheless, poor cost-estimating systems

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remain an area of concern at some contractors' locations and require continued attention by contractors and government contracting officials.

Maintaining public support for defense programs requires that potential fraud involving defense contractors be identified and dealt with swiftly. DOD has established a voluntary disclosure program to encourage defense contractors to report potential civil or criminal procurement fraud to the government. However, contractors' participation in the program has been relatively small and the dollar recoveries modest. Efforts to improve the administration of the program, including coordination between DOD and the Department of Justice, may encourage program participation and improve dollar recoveries.

As is the case with many other elements of defense, contract administration and audit resources have been reduced, and further reductions are planned. At the same time, DOD continues to look to additional outsourcing opportunities, and it plans to increase its procurement budgets significantly in the coming years. Both these actions may increase contracting actions and

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the need for effective contract administration and audits. As DOD seeks to reengineer and streamline its contracting and acquisition processes, including contract administration and audit, new business process techniques will be key to accomplishing effective and efficient oversight in the future.

We will continue to monitor DOD's progress in addressing the contract management issues discussed in this report.

Background

Over the last few years, many changes have been witnessed in the defense contracting environment—both within DOD and in the private contractor community. Between fiscal year 1991 and 1995, the defense procurement budget was reduced by almost 40 percent. Many defense contractors, in response to budgetary changes, substantially restructured their businesses. DOD, recognizing that it could no longer afford to buy weapon systems as it had in the past, began broad-based changes to its acquisition and contracting processes. With these changes, DOD is attempting to significantly improve the way it relates to its contractors and the rules governing their relationships. And the changes are by no means complete. Acquisition reform, with its emphasis on widespread reengineering of fundamental processes, continues to receive attention at the highest levels in DOD.

In spite of budget reductions and other changes, DOD's contracting activity remains substantial, amounting to about \$110 billion in fiscal year 1995. The risks associated with this level of contracting activity alone are high. The risk increases substantially when this activity is coupled with (1) continuing fundamental changes in the acquisition and contracting processes that have yet to be

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fully implemented or evaluated and (2) a contract administration and auditing resource base that has already been substantially reduced. Therefore, contract management must remain an area of potential high risk that receives marked DOD management attention.

DOD's Contract Payment Process Is Error Prone and Costly

The need for DOD to achieve effective control over its payment process is imperative. If it does not, it continues to risk erroneously paying contractors millions of dollars and perpetuating other financial management and accounting control problems. In recent years, we have reported on DOD's numerous problems in making accurate payments to defense contractors. These reports identify millions of dollars in government overpayments, underpayments, and interest on late payments, in addition to other financial management problems. For example, as we reported in our 1995 high-risk report, during a 6-month period in fiscal year 1993, DFAS in Columbus, Ohio—a principal DOD contract-paying activity—processed \$751 million in checks returned by defense contractors. Our examination of \$392 million of the \$751 million disclosed that about \$305 million, or about 78 percent, represented overpayments by the government. Later, we found that some contractors had retained overpayments. For example, in one case, a contractor was overpaid \$7.5 million due to numerous errors. The overpayment remained outstanding for 8 years. We estimate that the government lost interest on the overpayment amounting to nearly \$5 million. We concluded that neither DOD nor the

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responsible contractors appeared to be aggressively pursuing resolution of payment discrepancies.

As of May 1996, DOD reported that its problem disbursements totaled about \$18 billion. However, our preliminary work on DOD's reporting of problem disbursement data indicates that reported amounts are substantially understated. This understatement raises concerns over whether DOD has sufficient, reliable information to determine the extent to which disbursement problems have been reduced.¹

In our most recent review, we concluded that the following factors have contributed significantly to errors in DOD's payment process: (1) nonintegrated computer systems often require data to be entered manually, and the data are often erroneous or incomplete; (2) multiple documents must be matched before contractors are paid; and (3) payments are allocated among numerous accounting classifications. In addition to contributing to numerous errors, these factors increase the cost of paying contract invoices.

¹For a discussion of DOD's inability to resolve problem disbursements, see our Defense Financial Management high-risk report (GAO/HR-97-3).

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DOD is taking steps to address its payment problems. Its initiatives include testing and adopting some best practices. In the long term, it is developing procurement and payment systems that are linked by sharing common data. This linkage is expected to allow one-time entry of contract data critical to making correct payments. DOD plans to implement the payment system in fiscal year 1999 and to make both systems fully operational in 2004. In the meantime, DOD is enhancing its current technologies to further automate the payment process. DOD is also testing streamlined payment practices.

While DOD's planned procurement and payment systems could improve the accuracy and reliability of new contract payment data and reduce processing costs, they will not fully address the factors identified as contributing to payment problems. Ongoing contracts may be transferred to the new system with existing errors, multiple document matching will still be done, and payments will continue to require allocation among sometimes numerous accounting classifications.

Effective Cost-Estimating Systems Are Key to Sound Contract Prices

Cost-estimating systems that produce accurate price proposals are a key safeguard for obtaining fair and reasonable contract prices and minimizing overpricing. In the past, we found significant problems with contractors' cost-estimating systems. In July 1994, we reported that 11 of 30 DOD contractors had cost-estimating systems containing significant uncorrected deficiencies that had been outstanding an average of 3.8 years. Although DOD administrative contracting officers are responsible for determining the adequacy of the contractors' cost-estimating systems and requiring correction if the systems are deficient, we found that contracting officers were reluctant to use all available sanctions to encourage contractors to correct deficiencies. The failure to correct these deficiencies in a timely manner, we reported, creates a variety of problems for DOD, including increased costs and delays in contract award.

Based on our audit recommendations, DOD took steps to strengthen oversight of its contractors' estimating systems. Specifically, it issued new internal guidance for monitoring contractors' cost-estimating systems and established positions within Defense Contract Management Command

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(DCMC) district offices to serve as focal points for overseeing the status of contractors' cost-estimating systems. DOD now requires a biannual status report from administrative contracting officers on the status of outstanding deficiencies in contractors' estimating systems. According to these reports, the number of estimating system deficiencies has declined. However, DCAA's audits continue to identify proposals that lack complete, accurate, and current data. According to DCAA information, its audits of proposals have saved \$5.3 billion over the last 3 fiscal years.

Despite DOD's changes, some contractors continue to have long-outstanding deficiencies in their estimating systems. For example, one contractor had significant deficiencies dating to at least June 1992. According to a June 1992 DCAA audit report, this contractor had outdated support for its material estimates as well as other material and subcontractor cost deficiencies. Additional audits by DCAA in September 1993, May 1994, and April 1996 continued to find material estimating weaknesses, such as the use of undocumented judgmental cost estimates instead of vendor quotes and the use of outdated vendor quotes. In July 1996, the administrative contracting officer

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reported that the company's corrective action plan was being monitored by a contractor-government team. The contracting officer also said that the risk to the government is being minimized by more extensive government review during pre-award activities and increased scrutiny of contractor billings.

Because of the importance of accurate cost-estimating systems for producing sound contractor price proposals and the additional government resources and costs associated with the more extensive review required when contractors have deficient systems, DOD needs to continue to encourage contractors to resolve deficiencies in their estimating systems quickly. Where necessary to achieve compliance, government administrative contracting officers need to use the full range of tools available to them to motivate contractors to address estimating system deficiencies.

Improving the Administration of DOD's Voluntary Disclosure Program

In 1986, a report to the President on defense management concluded that the defense industry needed to promote principles of ethical business conduct, detect acts of procurement fraud through self-governance, and voluntarily report potential fraud to the government. In response to the report, a number of defense contractors established self-governance programs that included monitoring compliance with federal procurement laws and voluntarily disclosing violations to government authorities. These efforts became known as the Defense Industry Initiative on Business Ethics and Conduct.

To facilitate contractors' self-governance and encourage contractors to adopt a voluntary disclosure policy, DOD established the Voluntary Disclosure Program in July 1986. This program provides general guidelines, policy, and processes to enable DOD and its contractors to address matters of wrongdoing that contractors discover. At the time, DOD recognized that a process was needed for consistently handling matters disclosed by contractors. In return for voluntarily disclosing potential wrongdoing and cooperating in any government audit and investigation, the government generally allows contractors to conduct their own

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investigations, which the government then attempts to verify expeditiously.

We reviewed DOD's administration of its Voluntary Disclosure Program and found that contractors' participation in the program has been relatively small and the dollar recoveries modest. From its inception in 1986 through September 1994, DOD reported that of the thousands of defense contractors, 138 had made 325 voluntary disclosures of potential procurement fraud. DOD reported recoveries from these disclosures to be \$290 million, about 17 percent of the total reported DOD procurement fraud recoveries between fiscal year 1987 and 1994. However, our review indicated that DOD's reported recoveries of \$290 million were overstated because they included \$75 million in premature progress payments and amounts from disclosures made prior to the program.

We also found that DOD had accepted some disclosures in the program that the Justice Department believed were triggered by imminent government discovery and thus did not meet the criteria for admission. Further, contractors' less-than-full cooperation with the government and DOD's and other investigative agencies' low priority

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on managing cases expeditiously may have been problems in some cases.

Most disclosures did not result in significant dollar recoveries for the government. Of 129 closed cases, 81 cases, or about 63 percent, had reported recoveries of less than \$100,000, of which 52 cases, or 40 percent, had no dollar recoveries. Forty-eight cases had reported recoveries of \$100,000 or more, of which 15 cases had reported recoveries of \$2 million or more.

To ensure continued public support for defense programs, it is critical that potential fraud involving defense contractors be identified quickly and pursued aggressively. DOD's Voluntary Disclosure Program has the potential to contribute to that end, but improvements are needed. Efforts to improve the administration of the program, including improving coordination between DOD and the Department of Justice, could increase both program participation and dollar recoveries. Such improvements could also help reduce the risk to the government from procurement fraud.

Managing Future Contract Risk

DOD's budget declined from about \$311 billion in fiscal year 1991 to about \$254 billion in fiscal year 1996. However, beginning in fiscal year 1998, DOD projects a steady budget increase to about \$270 billion by fiscal year 2001. While DOD's contracting activity is related to the size of the defense budget, it is particularly related to trends in the procurement part of the budget. In this regard, DOD plans to increase its procurement budget from \$43 billion in fiscal year 1996 to \$60 billion by fiscal year 2001. As procurement activity increases, the amount of contracting and the demands for contract administration and audits are also likely to increase.

DCMC administers defense contracts, and DCAA audits them. Consistent with recent declines in the defense budget, resources for administering and auditing contracts have been cut significantly. However, unlike future defense budgets, contract administration and audit resources are expected to be cut back further. By fiscal year 2001, the staff at DCMC and DCAA are expected to be reduced to around 12,650 and 4,200, respectively—a reduction of about 41 and 32 percent from fiscal year 1991 levels.

Managing Future Contract Risk

DOD is also moving toward outsourcing more government functions. This is, perhaps, nowhere more apparent than in recent debates over privatizing depot maintenance workloads. DOD's depot maintenance is a vast undertaking, supporting millions of equipment items. DOD annually spends about \$15 billion on depot maintenance activities, and its depot maintenance facilities and equipment are valued at over \$50 billion. DOD and the Congress are redefining the role of DOD depots in the post-Cold War era, much in the same way the roles of U.S. war-fighting forces are being reshaped. While the new model for managing depot maintenance is evolving, there appears to be a clear shift toward greater reliance on the private sector. This shift affects force structure and the public and private activities' supporting force structure. It is also likely to affect the degree of DOD contracting activity.

If DOD increases procurement budgets, increases outsourcing, and reduces contract administration and audit resources, DOD will need to be creative in finding ways to meet an expected increase in demand for contract oversight and be more efficient in using its existing resources. In this regard, recent acquisition reform initiatives may create

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opportunities for DOD to redeploy oversight resources.

Further Action Needed

The need for DOD to achieve effective control over its payment process is imperative. If it does not, it continues to risk erroneously paying contractors millions of dollars and perpetuating other financial management and accounting control problems. While DOD is taking steps to improve its payment process and controls, other actions are needed to better ensure that payments are effectively monitored. Because of the effect of acquisition decisions on the payment system, it is most critical that the DOD Comptroller and the Under Secretary of Defense for Acquisition and Technology work together to ensure that changes in the acquisition process and systems do not place undue burdens on the payment system. The focus of changes should be to optimize the use of technology and simplify the payment process.

While the level of overpricing of defense contracts varies from year to year, overpricing remains an area that must continually be watched. Contractors may be deterred from overpricing if they know that the government will identify and deal with it aggressively. DOD must ensure that adequate systems and resources are available to protect government interests. Particularly important is the need to ensure that

Further Action Needed

contractors' cost-estimating systems are sound and that estimating deficiencies are quickly corrected. While DOD records indicate improvement, some contractors' systems still contain long-standing deficiencies. They must continue to be the focus of DOD's attention. Where appropriate, DOD contracting officials need to use the full range of tools to achieve contractors' compliance with requirements.

DOD's Voluntary Disclosure Program is intended to encourage defense contractors to report potential civil or criminal fraud to the government. To realize the maximum benefits from the program, increase program participation, and improve dollar recoveries, DOD needs to strengthen the administration of the program, including improving coordination between DOD and the Department of Justice.

DOD is facing uncertainty and potential risk in defense contracting in the future, given projected increases in procurement spending beginning in fiscal year 1998, increases in outsourcing, and further reductions in resources for administering and auditing contracts. Over the last few years, DOD has placed a high priority on streamlining and reengineering its contracting and acquisition

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processes, including contract administration and audit. These efforts are designed to reduce oversight requirements where little value can be gained and increase the efficiency of the acquisition process. DOD deserves much credit for these efforts. However, continued high-level management attention will be required to ensure success of the efforts underway. Furthermore, DOD will be challenged to find more efficient ways to meet contract administration and audit requirements with fewer resources. We will continue to monitor DOD's progress in addressing the contract management issues discussed in this report.

Related GAO Products

Defense Depot Maintenance: Privatization and the Debate Over the Public-Private Mix
(GAO/T-NSIAD-96-146, Apr. 16, 1996).

DOD Procurement: Use and Administration of DOD's Voluntary Disclosure Program
(GAO/NSIAD-96-21, Feb. 6, 1996).

DOD Procurement: Millions in Contract Payment Errors Not Detected and Resolved Promptly (GAO/NSIAD-96-8, Oct. 6, 1995).

High-Risk Series: Defense Contract Management (GAO/HR-95-3, Feb. 1995).

DOD Procurement: Overpayments and Underpayments at Selected Contractors Show Major Problem (GAO/NSIAD-94-245, Aug. 5, 1994).

DOD Procurement: Millions in Overpayments Returned by DOD Contractors
(GAO/NSIAD-94-106, Mar. 14, 1994).

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